Importance of Diversification

Competent investment management is critical to achieving returns and helping investors meet their financial goals. Over the next five weeks, the Trinidad and Tobago Securities and Exchange Commission (TTSEC) will be providing information on the topics of portfolio diversification, financial statements, the investment process, indicators of a viable investment opportunity and the impact of interest rates on investments. This week's article discusses two very important aspects of investment management, which include **Diversification and Asset Allocation**.

Diversification

Both individual and institutional investors may hold a diversified portfolio of investments rather than a portfolio concentrated in just a few types of investments. A key reason for this diversification is the desire to manage risk, which is consistent with the saying, "Don't put all your eggs in one basket." Diversification is one of the most important principles of investing. When securities with different characteristics are combined in a portfolio, the overall level of risk is typically reduced. Adding more unrelated securities to a portfolio will reduce risk through diversification.

The returns on investments in equities, bonds and mutual funds, will be affected by general economic conditions within Trinidad and Tobago. Returns will also be affected by issues that are specific to the particular investment. These two types of risk are respectively called systematic risk and specific risk.

Systematic risk, also known as market risk, is created by economic, social or political conditions that impact all companies within the market. For example, during a recession, many companies will see a downturn in their revenues and profits.

Specific risk, or an unsystematic risk, is a risk that is specific to a certain company or investment. An example of this is the share price response, up or down, when a company introduces a new product.

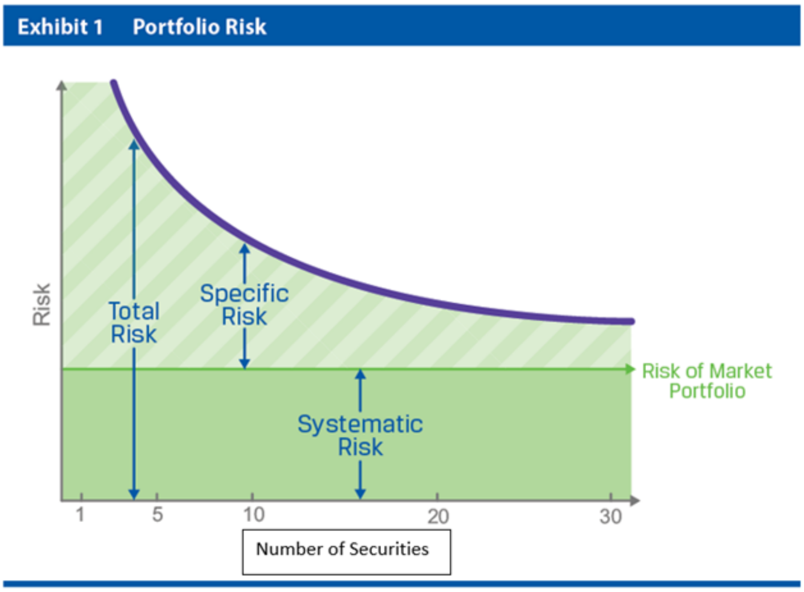

Exhibit 1. shows a reduction in specific risks, on the x axis, as they are diversified away through the purchase of additional securities in different companies.

Understanding the difference between systematic and specific risk is important because they both have varying implications for investors and the structure of their investment portfolios. Investors can reduce specific risk by adding a number of uncorrelated securities in their portfolios. In the securities market, correlation is a statistic that measures the degree to which two securities move in relation to each other. The greater the correlation between asset classes (or securities), the more similar their price movements will be.

Unlike specific risk, investors cannot diversify away systematic risk because all investments will be affected to some extent by systematic risk. For example, a recession will more than likely affect all securities and these economic conditions cannot be diversified away. Since systematic risk cannot be avoided or diversified away, investors tend to be compensated, via higher expected returns, for taking on such risk.

Asset Allocation

After assessing an investor's willingness and ability to take risk, the broker must determine the asset allocation of the portfolio. This involves decisions regarding which asset/security classes are suitable for the investor and the proportion of the portfolio to invest in these different asset/security classes. In some cases, the asset allocation decision is documented and agreed to by the client/investor. The asset allocation should assist in achieving the investor's objectives and can include a combination of local and foreign securities. The allocation within the investor's portfolio will reflect the information obtained by the registrant and the mix of securities can provide a sense of whether the investor's risk appetite is conservative, moderate or aggressive.

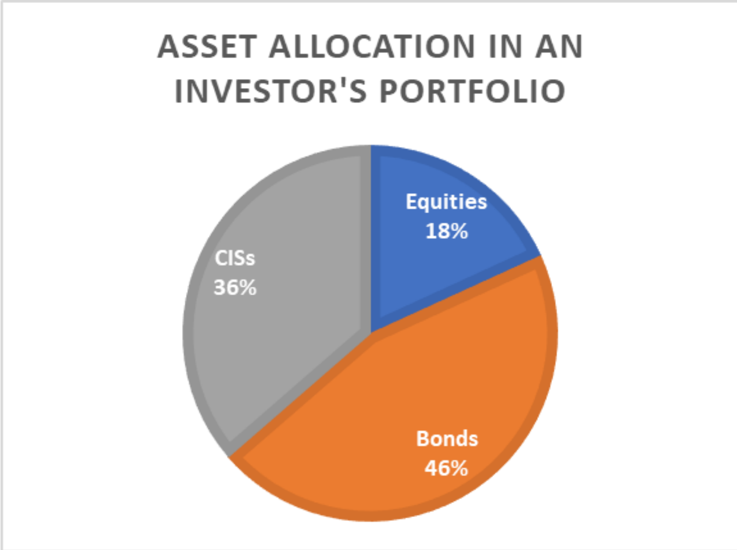

Exhibit 2

Exhibit 2. displays an allocation of assets/securities where the investor has 46% of their portfolio in bonds, 36% in CISs (mutual funds) and 18% in equities (stocks/shares).

As an investor's needs change over time, brokers may have to rebalance the investors asset allocation to ensure the objectives of the investor are being achieved. Rebalancing involves selling some of the holdings that have increased due to capital appreciation and reinvestment of earnings. Other securities can also be purchased to ensure the risk profile of the investor is reflected in the asset allocation. For example, the investor may be more willing to take on additional risk and hence the broker may suggest increasing the portion of investments in equities.

A critical concept is the fact that all investments carry some level of risk. It is therefore left up to the investor to determine their risk profile i.e. whether they are comfortable taking risks (risk-taker) or whether the risk makes them uncomfortable (risk-averse). In order to determine your risk-profile ask yourself these questions:

1) Am I a high risk-taker? If the value of my investment takes a dip - do I feel comfortable to ride it out?
2) Am I averse to risk? Would I lose sleep if the value of my assets took a sharp drop?

Every individual needs to assess what is right for him/her at each stage in life since one's life stage influences one's willingness to take risk. Most persons start saving when they begin working or have a permanent job and a steady income. The build-up of savings is what is used to start an investment portfolio. The aim is to create a sizeable portfolio of **diversified assets** that should last through to retirement, and possibly ride out risky investments.

Even if you may not have a great deal of assets now, you need to be aware of your options should you come into a sizeable amount of money. Every investor is unique, but everyone faces the same trade-off between risk and reward. In simple terms, one can't hope for long-term, above-average returns, unless one is willing to take on more risk. There is generally a positive relationship between risk and return, that is, the **higher the return, the greater the risk and the lower the return, the lower the risk.**

As such, the TTSEC encourages all investors in the securities industry to hold registrants, which includes, investment advisers and broker dealers, to high standards of quality that ensures ethically sound practices, compliance with regulation, and to be well organised. Just as importantly, investors must expect a return on the money they invest. Next week we shift our attention to financial statements, in our continuing focus on competent investment management.

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